United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

Signed

76-4199

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

ANGELO J. and IDA A. BIANCHI,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF THE ISSUES PRESENTED

1. Whether the Tax Court was correct in denying a deduction for the initial pension plan contribution allocable to taxpayer, on the ground that it did not qualify as reasonable compensation under Section 404(a) of the Internal Revenue Code of 1954, for the short taxable year in question.

2. Whether the Tax Court was correct in applying the negligence penalty imposed by Section 6653(a) of the Internal Revenue Code of 1954 to the entire deficiency.

STATEMENT OF THE CASE

This appeal involves a deficiency in income taxes for the year 1970 in the amount of $9,554.75, plus an addition to tax of $477.74, imposed as a negligence penalty under Section 6653(a) of the Internal Revenue Code of 1954. (R. 80.)[1] The findings of fact and opinion of the Tax Court (R. 80-100) are reported at 66 T.C. No. 35. The decision of the Tax Court, which determined that a deficiency in income tax in the above-stated amount existed in 1970, was entered on May 21, 1976. (R. 101.) The taxpayers[2] filed a timely notice of appeal on August 19, 1976. (R. 2.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts as found by the Tax Court (R. 80-88) are as follows:

The taxpayer is a dentist practicing in the Rochester, New York area. Upon graduation from the Dental College of the University of Buffalo in 1949, he served a one-year apprenticeship at the Eastman Dental Center, Rochester, New York, took a one-year course at St. Mary's Hospital, Rochester, New York, in general anesthesia, and then worked at Mt. Morris Tuberculosis Hospital, Mt. Morris, New York, for seventeen years administering general anesthesia, meanwhile maintaining a dental practice at the same time. He has participated in continuing education

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1/ "R." references are to the separately bound record appendix.

2/ "Taxpayer" refers to Angelo J. Bianchi. Ida A. Bianchi is a party to this action only because she joined in the filing of a joint income tax return for the years in issue.

programs, has attended annual University of Buffalo Dental Seminars over a period of 15 to 20 years, and has taken crown and bridge courses and a course in implantology at the Institute of Graduate Dentists in New York City. His practice as sole practitioner and as employee for Angelo J. Bianchi, P.C., consists of general dentistry with emphasis on crown and bridge work; he has done little work in the field of orthodontia. (R. 81-82.)

The taxpayer organized Angelo J. Bianchi, P.C., a professional service corporation under New York law, on November 23, 1970, transferring the equipment previously used by the taxpayer in his individual dental practice, as well as his accounts receivable and good will, for all of the corporation's stock. On November 24, 1970, the taxpayer, as president of the corporation, executed an Employees' Pension Trust Agreement[3/], and, on November 27, 1970, opened a trust account at the Bankers Trust Co., Rochester, New York. This plan, which became effective on November 30, 1970, provided that all employees between the ages of 25 and 56 were covered under the plan, there being no requirement of prior service with the employer to establish eligibility under the plan. The corporation agreed to pay the full cost of the plan

3/ On April 20, 1971, the District Director determined that the plan was a qualified trust under either Section 401 or 405 of the Internal Revenue Code of 1954. (R. 86.)

and to fund it by level payments to a trust established under the plan. This funding method, also known as split funding, is designed to accumulate with interest the amount of money necessary to purchase an annuity which will pay a predetermined benefit at retirement age over the estimated period of retirement. Under this plan, the retirement benefits were to be thirty percent of the participant's total compensation, based upon the average of the participant's five highest consecutive years of compensation, plus twenty percent of the participant's total compensation in excess of the amount provided as old age and survivors benefits under the Social Security Act. Under the plan the normal retirement age was to be 65 years of age, provided that the participant had participated in the plan for 10 years. Upon the participant's death, the plan would pay an amount equal to 70 times the normal retirement benefit. (R. 81-84.) In order to secure these benefits, the following contributions were to be made on behalf of the corporation's two employees (R. 84):

Employee	Annual Compensation	Expected Annual Benefit	Allocable Pension Plan Contribution
A. Bianchi	$48,000	$22,078	$16,470
S. Kravetz	7,540	2,262	523

On November 27, 1970, the corporation elected to be taxed as a small business corporation under Subchapter S of the Internal Revenue Code, with a fiscal year ending November 30. (R. 84.)

Some time between November 23 and 30, 1970, the taxpayer loaned the corporation $14,499.57, without interest, receiving a demand note. The corporation on November 30, 1970, deposited $16,993.41 in the trust account for the initial pension plan contribution, utilizing the amount borrowed from the taxpayer. In its initial income tax return, for the year November 23, 1970, to November 30, 1970, the corporation deducted the full amount of the initial pension plan contribution. It declared gross receipts for this one-week period of $1,340, and deductions, including the pension plan contribution, of $18,286.11, resulting in a net operating loss of $16,946.11 for the short taxable year. The amounts contributed by the corporation as pension plan payments which were allocable to the taxpayer were claimed on the corporation's annual income tax returns as follows (R. 84-85):

Taxable year ending November 30	Amount of contribution allocable to taxpayer
1970	$16,469.88
1971	17,023.82
1972	16,003.16
1973	16,900.24
1974	21,931.85

The taxpayer's income from the practice of dentistry over the years was as follows (R. 86-87, 96):

Year	Sole Proprietorship	Direct Corporate Compensation	Deferred Compensation	Total Compensation
1964	$47,620			$47,620
1965	38,039			38,039
1966	53,246			53,246
1967	62,450			62,450
1968	72,735			72,735
1969	75,702			75,702
1970 (1/1-11/23)	81,473			
(11/23-11/30)		$ 923.08	$16,469.88	
(12/1-12/31)		3,692.32		102,558.28
1971		48,000.16	17,023.82	65,023.98
1972		48,223.24	16,003.16	64,226.40
1973		48,000.16	16,900.24	64,900.40
1974		58,000.16	21,931.85	79,932.01

The services performed by the taxpayer for the corporation in the seven day taxable year beginning November 23, 1970, and ending November 30, 1970, were no different than those performed in any comparable period in 1971. (R. 87.)

After deducting taxpayer's salary and pension contributions, and the other expenses of the corporation, the corporation's taxable income or loss was as follows (R. 85):

Taxable year ending November 30	Taxable Income (Loss)
1970	$ (16,946.11)
1971	16,113.93
1972	13,027.89
1973	8,707.05
1974	3,915.97

The Commissioner in his notice of deficiency disallowed the $16,946.11 net operating loss deduction for the corporation's short taxable year, which had been passed through to taxpayer, determining that the allowable deduction for the corporation's

pension contribution for the short taxable year was 7/365 x $16,993.41, or $325.89, and, thus, that the corporation's correct net operating loss for the short taxable year was $278.59. The Commissioner also increased the taxpayer's income by $15,903.07, largely as a result of understatement of gross receipts, and asserted a negligence penalty under Section 6653(a) of the Code, on the total deficiency. (R. 7-11.) The Tax Court, in affirming the Commissioner's determination, ruled (1) that in determining the reasonability of the taxpayer's compensation for purposes of deductibility under Section 162 and 404(a) of the Code, all compensation, including corporate payments to the pension trust on behalf of the taxpayer should be considered; (2) that taxpayer had failed to meet his burden of establishing that his compensation for the seven day short taxable year ending November 30, 1970, was reasonable; and (3) that the Section 6653(a) negligence penalty was applicable to the entire deficiency for the taxable year if "any part of any underpayment" is due to fraud. The taxpayer appeals from each of those rulings.

SUMMARY OF ARGUMENT

I

The Tax Court was not clearly erroneous in ruling that taxpayers' receipt of $102,558.28 for services rendered as a dentist in 1970 was unreasonable, considering the fact that he received an average of $58,298.67 in the 1964 through 1969 period and an average of $68,520.70 in the 1971 through 1974 period, for the identical services. Moreover, the Tax Court was correct in rejecting the taxpayer's argument that his 1970 income, paid in part by his controlled Subchapter S corporation, was partial recompense for earlier under-compensated years as a sole practitioner. First, the best evidence of the reasonable compensation of a sole practitioner is the income which he has earned. Second, the Internal Revenue Service's stated position, supported by those courts which have considered the matter, is that the prior services of a self-employed individual may not be used to justify the reasonability of a salary paid to such individual as employee by a successor corporation. This is in accord with the requirement of Section 162 of the Code, made specifically applicable by Section 404 of the Code, that only a "reasonable allowance for salaries * * * for personal services actually rendered" is deductible, and the general rule mandating separate treatment of different taxable entities.

II

The Tax Court was correct as a matter of law in ruling that the negligence penalty is imposed by Section 6653(a) of the Code upon the entire underpayment of taxes, and not merely that portion of the deficiency which was the result of negligence, as this Court has recently held in Abrams v. United States, 449 F. 2d 662 (1971).

ARGUMENT

I

THE TAX COURT WAS CORRECT IN DENYING A DEDUCTION FOR THE INITIAL PENSION CONTRIBUTION ALLOCABLE TO TAXPAYER, ON THE GROUND THAT IT DID NOT QUALIFY AS REASONABLE COMPENSATION UNDER SECTION 404(a) OF THE INTERNAL REVENUE CODE OF 1954

The first issue raised by the taxpayers concerns the propriety of the Tax Court's disallowance of the initial pension contribution made on behalf of the taxpayer by his wholly owned Subchapter S corporation, Angelo Bianchi, P.C. The taxpayers assert that the $16,469.88 pension contribution made by the corporation on the taxpayer's behalf in a short taxable year beginning November 23, 1970 and ending November 30, 1970, qualified as a deductible employer pension contribution under Section 404(a) of the Internal Revenue Code of 1954, Appendix, infra, on two grounds: (1) the Tax Court was clearly erroneous in finding the taxpayer's compensation unreasonable; and (2) the Tax Court erred in refusing to consider the years of service performed by the taxpayer for the corporation's

predecessor, a sole proprietorship, in evaluating the reasonability of taxpayer's compensation in 1970.[4/]

Section 404(a) of the Internal Revenue Code of 1954, Appendix, infra, provides:

> (a) General Rule.--If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section * * *

Section 162 of the Code, Appendix, infra, provides in pertinent part:

> (a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--
>
> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

4/ On appeal the taxpayer does not press the argument made by it, and rejected by the court below (R. 89), that pension contributions, to be deductible under Section 404(a) of the Code, need only satisfy the "ordinary and necessary" requirements of Section 162, and not the "reasonable allowance for salaries" criterion found in Section 162(a)(1) of the Code. See Treasury Regulations on Income Tax (1954 Code), § 1.404(a)-1(b), Appendix, infra; Charles E. Smith & Sons Co. v. Commissioner, 184 F. 2d 1011 (C.A. 6, 1950), cert. denied, 340 U.S. 953 (1951). Nor does he continue to urge that in evaluating "reasonable compensation" one should consider only the amount of actual renumeration, and make no reference to indirect compensation in the form of pension benefits. See § 1.404(a)-1(b), supra. See, generally, Edwins, Inc. v. United States, 501 F. 2d 675 (C.A. 7, 1974).

As to the first contention, the Tax Court was not bound to accept the testimony of the taxpayer and his witnesses that the taxpayer's salary was reasonable, under the circumstances, since the facts of record clearly contradicted that allegation, as the Tax Court held: "It cannot be questioned that the clearest evidence of the worth of petitioner's services is petitioner's earnings from his dentistry practice as an individual proprietor." (R. 95.) As the Tax Court noted (R. 96), the taxpayer's yearly income derived from his performance of dentistry services as a sole practitioner in the 1964 through 1969 period varied from $38,039 to $75,702, or an average of $58,298.67. Compensation, including deferred compensation, paid to him in the 1971 through 1974 period varied from $64,226 to $79,932.01, or an average of $68,520.70. In 1970, however, the taxpayer received $81,473 from his sole proprietorship, $3,692.32 as wages from the newly formed corporation for a one-month period, and $923.08 as wages and $16,469.88 as deferred compensation for services performed in a one-week period, or total compensation in 1970 of $102,558.28. No showing was made that the services performed by the taxpayer in the 1964 through 1969 period were any different in nature or extent from the services performed by the taxpayer in 1970, or that the taxpayer's services in 1970 varied in any way from the services

performed by him in the 1971 through 1974 period.[5/] The record, in short, fails to demonstrate why the taxpayer's income in one year, 1970, was 176 percent of the average income for the previous six years, or why the taxpayer's income immediately fell, in the 1971 through 1974 taxable period, back to an average which roughly compared to his income earned in the pre-1970 years. Clearly the best evidence of the reasonability of the taxpayer's compensation is the amount which he was able to earn for himself in the period preceding incorporation of his professional occupation, as well as the amount which he earned in the years succeeding incorporation for his professional services. There being support in the record for the Tax Court's conclusion that the taxpayer received compensation in 1970 which was not "reasonable," the Tax Court's findings in this regard should be affirmed as not clearly erroneous (see Willmark Service System, Inc. v. Commissioner, 368 F. 2d 359 (C.A. 2, 1966)), unless the lower court erred in refusing to consider the value of services performed by the taxpayer as sole practitioner before his contract of employment with the corporation began.

Nor is there merit to the taxpayer's second contention--that the high 1970 income received by the taxpayer reflected an attempt to adjust his under-compensated state in years prior

5/ The taxpayer testified that the services rendered by him between November 23, 1970, and November 30, 1970, were no different from the services performed by him between December 1, 1970, and November 30, 1971. (R. 41.)

to incorporation of the professional corporation, and should, for that reason, be found reasonable.[6/] This argument lacks merit, first, for the very reasons which require rejection of his initial argument: the facts fail to establish that the taxpayer, when operating as a sole practitioner in the years 1964 through 1969, was in fact under-compensated for his efforts. He, as the sole performer of the services for which he was being paid, was in a position to charge what the market would bear, and there is no evidence that he failed to do so. His situation had nothing in common with the usual "reasonable compensation" case, where the recipients are able to establish that prior salaries were lower than normal because the recipients desired that the corporation's profits be used to expand the business. Cf. R. J. Nicoll Co. v. Commissioner, 59 T.C. 37 (1972). In such a case, the suggestion of some other market--the wages offered by others, for example--justifies comparison with other competitive wages. In the instant case, on the other hand, as the Tax Court appreciated (R. 99), "the best evidence of the value of his personal services is profit he derived from his own practice."

6/ While Carillo testified that the taxpayer's earnings from 1964 through 1974 were "kind of low" and that he was "definitely under-compensated" (R. 73-74), nothing in the taxpayer's testimony indicated that he considered himself under-compensated, or that the large increase in compensation received by him in 1970 had anything to do with any attempt to make up for earlier lean years. Nor did the plan in this case make any provision for any past service credits. (See Ex. 2-B, Art. 6, Sec. 2(b)(iii)(2).)

The argument that the corporation's payment of excessive compensation should be considered reasonable as reflecting taxpayer's under-compensation as a sole practitioner also lacks merit as a matter of law. It is the Internal Revenue Service's position, upheld by those courts which have considered the matter, that it is improper to refer to the prior service of a self-employed individual, in determining the reasonability of compensation paid by a successor corporation, because the prior service was not performed for the employer-corporation. See U.S. Asiatic Co. v. Commissioner, 30 T.C. 1373 (1958); Underwriters' Laboratories, Inc. v. Commissioner, 46 B.T.A. 464 (1942); Rev. Rul. 71-502, 1971-2 Cum. Bull. 199; Rev. Rul. 69-421, 1969-2 Cum. Bull. 59; Rev. Rul. 69-144, 1969-1 Cum. Bull. 115; Rev. Rul. 69-36, 1969-1 Cum. Bull. 128. Cf. Treasury Regulations on Income Tax (1954 Code), Section 1.404(a)-1(b), supra, providing that prior services rendered by an employee of the employer-contributor may be taken into account in determining what is a reasonable allowance for compensation in the taxable year in question, and Treasury Regulations on Income Tax (1954 Code), Section 1.401-10(b)(3)(i) (26 C.F.R.), noting that "The term 'employee', for [the] purposes of section 401, does not include a self-employed individual when the term 'common-law' employee is used or when the context otherwise requires that the term

'employee' does not include self-employed individual.[7/]" As explained by Treasury Regulations, Section 1.404(a)-1(b), supra:

> What constitutes a reasonable allowance depends on the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as [in] the current year * * *. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year.

This Regulation's requirement that only services "actually rendered" to the contributor may be considered in determining the extent of reasonable compensation is drawn directly from Section 162 of the Code, which, as has been shown, supra, must be satisfied before a pension contribution may be found deductible. Section 162(a)(1) of the Code, it should be recalled, permits a business expense deduction for amounts paid or incurred by the taxpayer as "a reasonable allowance for salaries or other compensation for personal services actually rendered." Clearly the statutory language prohibits a

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7/ See Treasury Regulations on Income Tax (1954 Code) Section 1.401-11(b)(2) (26 C.F.R.), noting the changes made by the Self-Employed Individuals Retirement Act of 1962, P.L. 87-792, 76 Stat. 809, which permits self-employed individuals to be treated as employees in order to obtain restricted benefits of qualified pension plans.

deduction for payments made for services rendered to one other than the taxpayer. See U. S. Asiatic Co. v. Commissioner, supra.[8] This is in accord with the general rule which respects the separate entity of the corporation, for tax purposes. See Moline Properties v. Commissioner, 319 U.S. 436, 438-439 (1943); National Carbide Corp. v. Commissioner, 336 U.S. 422, 434 (1949); Burnet v. Clark, 287 U.S. 410 (1932).[9]

The Tax Court's disallowance of taxpayer's excess compensation is correct and should be affirmed by this Court.

8/ Nor is there merit to the taxpayer's assertion that the corporation should be considered as having paid assumed accounts payable of the predecessor sole proprietorship, since the record fails to establish the existence of any contractual obligation on the proprietorship's part to "pay" the sole proprietor additional wages, even if such hypothetical agreement may be imputed between a sole proprietorship and the sole proprietor.

9/ Another consideration supporting the Tax Court's refusal to credit a sole proprietor's past service in determining the amount which may be deducted by a successor corporate-employer as a pension contribution for reasonable compensation is the fact that the Code clearly provides for different limitations upon the amount which may be deducted for employer contributions and the amount which self-employed individuals may deduct as pension contributions. Cf. Sec. 404(a)(1) and 404(e) of the Internal Revenue Code of 1954, Appendix, infra. It is also noteworthy that this taxpayer, by selecting a seven-day short taxable year, avoided the effect of Section 1379(b) of the Code (26 U.S.C), effective for years beginning after December 31, 1970, which requires shareholder-employees to include in income the excess of contributions over the lesser of $2,500 or 10 percent of compensation.

II

THE TAX COURT WAS CORRECT IN APPLYING THE NEGLIGENCE PENALTY IMPOSED BY SECTION 6653(a) OF THE INTERNAL REVENUE CODE OF 1954 TO THE ENTIRE DEFICIENCY

Finally, the taxpayer urges (Br. 22) that, "despite the seemingly overwhelming jurisprudence to the contrary," this Court should in any event abate the negligence penalty imposed by Section 6653(a) of the Internal Revenue Code of 1954 to that part of the deficiency relating to the issue on appeal, because the underpayment of taxes with respect to that issue was done on the advice of experts. Taxpayer does not dispute the fact, however, that another portion of the underpayment was attributable to negligence, mandating the application of Code Section 6653(a). Section 6653(a) of the Code, Appendix, infra, provides that:

> If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment. (Emphasis supplied.)

Section 6653(c) (26 U.S.C.), defines "underpayment" as a "deficiency" under Section 6211, Appendix, infra, which defines that latter term as follows:

> * * * the term "deficiency" means the amount by which the tax imposed by subtitle A or B or chapter 42 exceeds the excess of--
>
> (1) the sum of
>
> (A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus
>
> (B) the amounts previously assessed (or collected without assessment) as a deficiency, over--
>
> (2) the amount of rebates, as defined in subsection (b)(2), made.

This Court in Abrams v. United States, 449 F. 2d 662 (1971) has considered and rejected the very argument raised by the taxpayer in this case, noting that the negligence penalty imposed by Section 6653(a), as well as the fraud penalty imposed by Section 6653(b) (26 U.S.C.), "are in fact penalties and their imposition on [the] entire tax deficiency for [the] year * * * [is] not only clearly provided for * * * [in the] statute but * * * [serves] as a deterrent." See also Mensik v. Commissioner, 37 T.C. 703 (1962), aff'd, 328 F. 2d 147 (C.A. 7, 1964), cert. denied, 379 U.S. 827 (1964); Stewart v. Commissioner, 66 T.C. 54 (1976). Cf. Papa v. Commissioner, 464 F. 2d 150 (C.A. 2, 1972).

CONCLUSION

For the above-stated reasons, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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NOVEMBER, 1976.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 12th day of November, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

* * *

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) [as amended by Sec. 24, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] General Rule.--If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

(1) Pension trusts.--In the taxable year when paid, if the contributions are paid into a pension trust, and if such taxable year ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), in an amount determined as follows:

(A) an amount not in excess of 5 percent of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust,

but such amount may be reduced for future years if found by the Secretary or his delegate upon periodical examinations at not less than 5-year intervals to be more than the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan, plus

(B) any excess over the amount allowable under subparagraph (A) necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, as determined under regulations prescribed by the Secretary or his delegate, but if such remaining unfunded cost with respect to any 3 individuals is more than 50 percent of such remaining unfunded cost, the amount of such unfunded cost attributable to such individuals shall be distributed over a period of at least 5 taxable years, or

(C) in lieu of the amounts allowable under subparagraphs (A) and (B) above, an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Secretary or his delegate, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of 10 percent of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan, as determined under regulations prescribed by the Secretary or his delegate, except that in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased.

* * *

(e) [as added by Sec. 3(b), Self-Employed Individuals Tax Retirement Act of 1962, P.L. 87-792, 76 Stat. 809; amended by Sec. 204(b), Act of November 13, 1966, P.L. 89-809, 80 Stat. 1539] Special Limitations for Self-Employed Individuals.--

(1) In general.--In the case of a plan included in subsection (a)(1), (2), or (3), which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), the amounts deductible under subsection (a) in any taxable year with respect to contributions on behalf of any employee within the meaning of section 401(c)(1) shall, subject to the provisions of paragraph (2), not exceed $2,500, or 10 percent of the earned income derived by such employee from the trade or business with respect to which the plan is established, whichever is the lesser.

* * *

SEC. 6211. DEFINITION OF A DEFICIENCY.

(a) [as amended by Sec. 101(f)(1), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487] In General.--For purposes of this title in the case of income, estate, gift, and excise taxes, imposed by subtitles A and B, and chapter 42, the term "deficiency" means the amount by which the tax imposed by subtitle A or B or chapter 42 exceeds the excess of--

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency over--

(2) the amount of rebates, as defined in subsection (b) (2), made.

* * *

SEC. 6653. FAILURE TO PAY TAX.

(a) Negligence of Intentional Disregard of Rules and Regulations With Respect to Income or Gift Taxes.-- If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.404(a)-1 Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

* * *

(b) In order to be deductible under section 404 (a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404 (a) that they are deductible, if at all, only under section 404 (a). Contributions may therefore be deducted under section 404 (a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered. In no case is a deduction allowable under section 404 (a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of

additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. * * *

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